

COMMISSIONERS
MIKE GLEASON - Chairman
WILLIAM A. MUNDELL
JEFF HATCH-MILLER
KRISTIN K. MAYES
GARY PIERCE

OPEN MEETING ITEM



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Executive Director

ORIGINAL

ARIZONA CORPORATION COMMISSION

DATE: NOVEMBER 12, 2008

DOCKET NO: E-01345A-08-0172

TO ALL PARTIES:

Arizona Corporation Commission

DOCKETED

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Enclosed please find the recommendation of Administrative Law Judge Lyn Farmer. The recommendation has been filed in the form of an Opinion and Order on:

ARIZONA PUBLIC SERVICE COMPANY
(INTERIM RATES)

Pursuant to A.A.C. R14-3-110(B), you may file exceptions to the recommendation of the Administrative Law Judge by filing an original and ten (10) copies of the exceptions with the Commission's Docket Control at the address listed below by **4:00** p.m. on or before:

NOVEMBER 21, 2008

The enclosed is NOT an order of the Commission, but a recommendation of the Administrative Law Judge to the Commissioners. Consideration of this matter has tentatively been scheduled for the Commission's Working Session and Open Meeting to be held on:

TO BE DETERMINED

For more information, you may contact Docket Control at (602) 542-3477 or the Hearing Division at (602)542-4250. For information about the Open Meeting, contact the Executive Director's Office at (602) 542-3931.

Brian C. McNeil

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

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1 **BEFORE THE ARIZONA CORPORATION COMMISSION**

2 **COMMISSIONERS**

3 MIKE GLEASON - Chairman
4 WILLIAM A. MUNDELL
5 JEFF HATCH-MILLER
6 KRISTIN K. MAYES
7 GARY PIERCE

8 IN THE MATTER OF THE APPLICATION OF
9 ARIZONA PUBLIC SERVICE COMPANY FOR A
10 HEARING TO DETERMINE THE FAIR VALUE
11 OF THE UTILITY PROPERTY OF THE
12 COMPANY FOR RATEMAKING PURPOSES, TO
13 FIX A JUST AND REASONABLE RATE OF
14 RETURN THEREON, AND TO APPROVE RATE
15 SCHEDULES DESIGNED TO DEVELOP SUCH
16 RETURN.

DOCKET NO. E-01345A-08-0172

DECISION NO. _____

INTERIM RATE CASE
OPINION AND ORDER

12 DATES OF HEARING: September 11, 2008 (Public Comments), September 15,
13 16, 17, 18, and 19, 2008.

14 PLACE OF HEARING: Phoenix, Arizona

15 ADMINISTRATIVE LAW JUDGE: Lyn Farmer

16 IN ATTENDANCE: Mike Gleason, Chairman
17 William A. Mundell, Commissioner
18 Kristin K. Mayes, Commissioner
19 Gary Pierce, Commissioner

20 APPEARANCES: Mr. Thomas L. Mumaw and Ms. Meghan H. Grabel,
21 PINNACLE WEST CAPITAL CORPORATION, and
22 Mr. William J. Maledon, OSBORN MALEDON, on
23 behalf of Applicant;

24 Mr. Michael M. Grant, GALLAGHER & KENNEDY,
25 on behalf of Arizona Investment Council;

26 Mr. Daniel Pozefsky, Chief Counsel, on behalf of the
27 Residential Utility Consumer Office;

28 Mr. C. Webb Crocket, FENNEMORE CRAIG, P.C., on
behalf of Freeport-McMoRan and Arizonans for Electric
Choice and Competition;

Ms. Karen E. Nally, MOYES, SELLERS & SIMS, on
behalf of AZ-Ag Group;

Mr. William P. Sullivan, CURTIS, GOODWIN,
SULLIVAN, UDALL & SCHWAB, P.L.C., on behalf
of the Town of Wickenburg;

1 Mr. Lawrence V. Robertson, Jr., on behalf of Mesquite
2 Power, LLC, Southwestern Power Group, II, LLC; and
3 Bowie Power Station, LLC; and

4 Ms. Maureen Scott, Senior Staff Counsel, and Ms.
5 Amanda Ho and Mr. Charles Hains, Staff Attorneys,
6 Legal Division, on behalf of the Utilities Division of the
7 Arizona Corporation Commission.

8 **BY THE COMMISSION:**

9 On March 24, 2008, Arizona Public Service Company ("APS") filed with the Arizona
10 Corporation Commission ("Commission") an application for a rate increase.

11 On April 2, April 8, and April 14, 2008, The Kroger Company ("Kroger"); Freeport-
12 McMoRan Copper & Gold, Inc. and Arizonans for Electric Choice and Competition (together,
13 "AECC"); and Mesquite Power, L.L.C., Southwestern Power Group II, L.L.C., and Bowie Power
14 Station, L.L.C. (collectively "Mesquite"), respectively, filed Motions to Intervene.

15 On April 30, 2008, the Town of Wickenburg filed a Motion to Intervene.

16 By Procedural Orders issued on April 25 and May 19, 2008, the Motions to Intervene were
17 granted.

18 On June 2, 2008, APS filed an Amended Application.

19 On June 6, 2008, APS filed a Motion for Approval of Interim Rates and Preliminary Order
20 ("Motion") and requested a procedural conference be scheduled. In its Motion, APS requested the
21 Commission approve an "Interim Base Rate Surcharge" of \$.003987 per kWh to be effective upon
22 the expiration of the \$.003987 per kWh 2007 Power Supply Adjustor ("PSA") charge granted in
23 Decision No. 69663 (June 28, 2007).

24 On June 13, 2008, a Procedural Order was issued scheduling a procedural conference on
25 APS' Motion. Also on June 13, 2008, Western Resource Advocates and Southwest Energy
26 Efficiency Project ("WRA/SWEEP") filed a Petition for Leave to Intervene.

27 On June 16, 2008, the Residential Utility Consumer Office ("RUCO") filed an Application to
28 Intervene.

On June 19, 2008, the Arizona Investment Council ("AIC") filed a Motion to Intervene.

On June 19, 2008, the procedural conference was held as scheduled. Intervention was granted

1 to WRA/SWEEP, RUCO, AIC, and the Az-Ag Group.¹ The parties were directed to meet and
2 discuss the Motion to see if there could be agreement on the procedural timeframes for the actions
3 requested by APS in its Motion and whether the parties could reach any other agreements. The
4 parties were directed to file either a joint recommendation or separate recommendations by June 30,
5 2008.

6 On June 30, 2008, the parties filed a Recommended Procedural Schedule.

7 On July 16, 2008, a Procedural Order was issued scheduling a hearing on the APS Motion to
8 commence on September 15, 2008, and establishing associated procedural requirements and
9 deadlines; setting a public comment session and procedural conference for September 11, 2008; and
10 setting dates for the prefiling of witness testimony.

11 On July 23, 2008, the Hopi Tribe filed a Motion to Intervene, which was granted by
12 Procedural Order issued on August 4, 2008.

13 On July 29, 2008, a Procedural Order was issued scheduling the hearing on the permanent rate
14 case to commence on April 2, 2009.

15 On August 6, 2008, APS filed proof of publication of notice of hearing in compliance with the
16 July 16, 2008, Procedural Order.

17 On September 16, 2008, Commissioner Mayes docketed a letter requesting the parties to
18 address various issues during the hearing.

19 The public comment session and the evidentiary hearing were held as scheduled, with the
20 hearing concluding on September 20, 2008. APS presented testimony from William Post, Donald
21 Brandt, Charles Cicchetti, and David Rumolo. AECC presented testimony from Kevin Higgins,
22 RUCO presented testimony from Stephen Ahearn, and Staff presented testimony from Ralph Smith
23 and David Parcell.

24 On September 26, 2008, APS filed its late-filed Exhibit 22.

25 On October 3, 2008, Chairman Gleason docketed a letter concerning the cost to ratepayers if
26 APS' credit rating falls to junk status and asking APS to respond.

27
28 ¹ Counsel for Az-Ag Group orally requested intervention during the procedural conference.

1 Initial Closing Briefs were filed by APS, AIC, AECC, Mesquite, RUCO, and Staff on
2 October 3, 2008, and Reply Briefs were filed by APS, AIC, AECC, RUCO, and Staff on October 8,
3 2008.

4 On October 9, 2008, APS responded to Chairman Gleason's letter.

5 On October 14, 2008, APS filed its late-filed Exhibit 23.

6 DISCUSSION

7 APS' Position

8 In its Motion, APS requested an interim base rate surcharge of \$.003987 per kWh to be
9 effective upon the expiration of the 2007 PSA adjustor charge,² which was expected to occur in July
10 or early August 2008. The Motion does not request continuation of a PSA charge, but rather
11 implementation of a new "surcharge" that would collect \$115 million in base rates on an annual
12 basis. Like the PSA charge, the interim base rate surcharge would exempt E-3 and E-4 low income
13 customers, E-36 customers, and the solar rate schedules Solar-2 and SP-1. According to the Motion,
14 as of May 31, 2008, APS had expended "over \$1.7 billion for new facilities that are not included in
15 current rates," and APS asks to recover on an interim basis the "higher costs of owning and operating
16 such infrastructure investment." APS asserts that its earnings and cash flow are inadequate to finance
17 its capital needs and so it "must borrow huge sums to keep up with the needs of APS customers."
18 According to the Motion, approval of the interim rates would increase APS' return on equity,
19 providing an additional \$69 million in earnings on an annual basis that APS says "would be
20 reinvested in infrastructure and technology necessary to serve APS customers and reduce the need for
21 external debt financing."

22 Donald Brandt, President and Chief Executive Officer of APS and President and Chief
23 Operating Officer of Pinnacle West Capital Corporation ("Pinnacle West") testified in support of the
24 requested interim surcharge. Mr. Brandt testified that APS' distribution, transmission, generation
25 plant improvements, and new environmental control systems infrastructure investment requirements
26 have increased and that the underlying cost of material, commodities, and land for construction of
27 _____

28 ² In Decision No. 69663, the Commission authorized the continuation of the 2007 PSA after January 31, 2008, in order to collect the remaining \$46 million of 2007 fuel and purchased power costs.

1 this infrastructure has also increased. He testified that there are three ways to fund plant: using
2 retained earnings, new debt, or new equity infusions. Mr. Brandt testified that APS did not earn its
3 “authorized return on equity” in 2007 and, with the current rates, expects its “earning shortfall” to
4 continue. He also testified that APS’ net cash flow for the past five years shows that APS’ financial
5 health has weakened considerably. According to Mr. Brandt, between 1993 and 2003, “APS was
6 able to limit its cash expenditures to the amount of cash the Company took in, resulting in positive
7 net cash flow and a financially strong utility.”³ He testified that beginning in 2003, APS’ cash
8 outlays exceeded its cash receipts, resulting in a negative cash flow and weakened credit metrics. Mr.
9 Brandt believes that APS’ poor financial performance has caused Pinnacle West’s stock value to fall,
10 which could lead to APS’ inability to attract sufficient equity investment. According to Mr. Brandt,
11 if APS cannot obtain equity, then it must borrow more funds or delay projects. The cost of the new
12 debt will depend upon the Company’s credit ratings. Mr. Brandt testified that “APS’s credit ratings
13 on its outstanding debt are currently among the lowest that they can possibly be without being
14 regarded as ‘junk,’ rated ‘BBB-’ by Standard and Poor’s (‘S&P’), ‘BBB’ by Fitch Ratings (‘Fitch’),
15 and ‘Baa2’ by Moody’s Investor’s Service (‘Moody’s’).”⁴ He testified that to keep a BBB rating,
16 S&P expects APS in its present “business profile” category to maintain a Funds from Operations to
17 Debt ratio (“FFO/Debt”) between 18 percent and 28 percent.⁵ Mr. Brandt believes that the credit
18 ratings agencies are concerned about APS’ credit metrics, including its cash flow and earnings, and
19 will likely downgrade APS if interim rates are not approved. He testified that the “consequences of a
20 downgrade are dramatic and enduring” and will likely cause APS to incur higher interest rates,
21 resulting in increased costs of between \$70 million to \$145 million per year, or \$1 billion over the
22 next ten years.⁶ Mr. Brandt also believes that a downgrade might cause APS to lose all access to the
23 credit markets. Mr. Brandt disagrees with Staff’s and RUCO’s positions that the Company is
24 experiencing ordinary regulatory lag, instead characterizing it as “extraordinary regulatory lag.”⁷ Mr.
25 Brandt claims that “[s]uch extraordinary delay under the Company’s current operating conditions

³ Ex. APS-1 at 8.

⁴ *Id.* at 11.

⁵ *Id.* at 12.

⁶ *Id.* at 13.

⁷ Ex. APS-2 at 6.

1 institutionalizes economic confiscation of invested capital and causes APS significant financial harm
2 that threatens its already precarious credit metrics.”⁸ Although Mr. Brandt acknowledged that the
3 Commission has recently approved several adjustment mechanisms for APS, he stated that except for
4 the Transmission Cost Adjustor, they are “simply operating cost pass-through provisions, which do
5 not provide earnings to the Company.”⁹ Mr. Brandt also claims that the current rates do not allow
6 APS to recover its cost of service and have not for years. In response to Staff’s position that no credit
7 rating agency has indicated that a downgrade would result absent an interim increase, Mr. Brandt
8 testified that “[a]s those experienced in the industry are well aware, credit rating agencies do not
9 telegraph or otherwise expressly communicate to the utility or the public what specific impact a
10 potential future event will have on that company’s credit rating before the event occurs.”¹⁰ However,
11 he also testified that he had participated in conference calls with Moody’s personnel and was told that
12 APS needed credit metrics in the upper part of the range and that he had had a separate, in-person,
13 meeting with S&P representatives, who said that after the Commission rules on this interim request,
14 S&P will be reevaluating APS’ credit rating status in its ratings committee.¹¹ Mr. Brandt disagrees
15 with Staff’s witness’ belief that Value Line and S&P stock evaluations indicate Pinnacle West
16 compares favorably against other electric utilities when evaluating credit worthiness. Mr. Brandt
17 testified that the interim request will benefit customers:

18
19 But even setting aside for a moment the substantial potential for downgrade, there
20 is little question that the requested interim relief will improve the Company’s
21 earnings during the course of the general rate proceedings, which result itself will
22 ultimately benefit customers. The belief that any action that inures to the benefit
23 of shareholders must necessarily also be to the detriment of customers is simply
24 wrong. The Company’s ability to attract capital at reasonable prices such that it
can provide reliable service and invest in customer-beneficial programs and
sustainable technologies depends entirely upon its financial strength. The better
APS’s financial health, the lower the cost of capital that will ultimately be paid by
customers to finance the projects from which they importantly benefit.

25 The converse is also true: the more the Commission artificially depresses electric
26 prices in the short run, the worse the Company’s financial health and the harder it

27 ⁸ *Id.*

⁹ *Id.* at 15.

¹⁰ *Id.* at 26.

¹¹ *Id.* at 26-27.

1 will be for the Company to attract the capital it needs at reasonable prices. Equity
2 capital invariably flows to where it can earn the best risk-adjusted returns, which
3 means that the Company's *actual* rate of return is more important than its *allowed*
4 rate of return. The better the Company's actual ROE, the better the terms on
5 which the Company can issue equity. Because, as I have discussed, the
6 Company's actual rate of return is significantly and negatively impacted by
7 regulatory lag, any measure that reduces that impact and improves the Company's
8 earnings will also improve the Company's chances of attracting needed capital at
9 lower costs, thus keeping customer costs down in the long run. Because granting
10 the Company's interim rate request will mitigate the impact of APS's extensive
11 regulatory lag and improve the Company's ROE, it will also improve the
12 Company's likelihood of being able to finance its necessary capital spending with
13 a lower cost of capital, thus providing substantial benefits to customers.¹²

14 Mr. Brandt testified that even though the amount of the requested interim surcharge was based
15 upon the then-existing PSA charge, the \$115 million increase remains an appropriate amount to
16 recover through interim base rates because it provides a reasonable level of protection against a
17 downgrade; it generates an amount that is less than what APS is likely to receive in the permanent
18 rate case and thus will not likely need to be refunded; and if it is implemented in November, it will
19 coincide with the rate decrease associated with the change to winter rates. In response to Staff's
20 alternative recommendation, APS stated that it believes such an analysis, with two adjustments,¹³
21 supports an even larger increase than requested by APS – somewhere between \$95 million and \$247
22 million. Mr. Brandt agreed with Staff's modified alternative recommendation that does not require
23 an equity issuance in order to implement interim rates.

24 Dr. Charles Cicchetti, an economic consultant, and former Chair of the Wisconsin Public
25 Service Commission, testified on behalf of APS in support of its Motion. Dr. Cicchetti believes that
26 APS' declining financial condition is a customer emergency and that the Commission should begin to
27 address it by adopting an interim surcharge to replace the PSA adjustor. In response to Staff's
28 argument that there is no emergency, Dr. Cicchetti testified that the "current financial challenges will
only get worse if not addressed before the end of 2009," and "interim relief is clearly warranted from
a cost-of-service standpoint and to help keep retail prices lower over time."¹⁴ In response to Staff's

¹² *Id.* at 35-36.

¹³ Inclusion of book depreciation expense and use of a different time period. *Id.* at 38.

¹⁴ Ex. APS-13 at 3.

arguments about ordinary regulatory lag, Dr. Cicchetti disputed both that the amount not recovered is too small to be an emergency and that such lag can serve as a method to improve a utility's performance.

David Rumolo, APS Manager of Regulation and Pricing, testified concerning the methods for implementing the interim base rate surcharge. The Company analyzed three alternatives for assessing the surcharge: on a per kWh basis similar to the Interim PSA Adjustor, as a percentage adder to base bills using an equal percentage increase for all customers, and on a per kWh basis except for general service customers whose base rates include demand charges. According to Mr. Rumolo, each method collects the same revenue but has different impacts on customer classes. APS is willing to implement any of the methods and noted that the per kWh method tends to benefit small energy users such as residential customers and that the percentage method tends to favor large users. APS does not plan to charge the interim rates to customers who receive service under the low-income and medical equipment rate schedules, since they were exempt from the PSA adjustor. In his rebuttal testimony, Mr. Rumolo presented calculations that modified Staff's alternative recommendation to include revenue requirements associated with additional operating costs (depreciation expense and property taxes) and additional generation investment.

William Post, the Chairman of the Board for APS and Chairman and CEO for Pinnacle West, testified in support of APS' requested interim rate relief. Mr. Post testified that the proceeding provides an opportunity for the Commission and APS to address the state's energy future. He testified that the Commission should grant the Motion to:

(1) reduce regulatory lag; (2) send a strong message to the capital markets and to the industry as a whole that the Commission shares with APS the goal of acquiring capital at the lowest possible cost consistent with high customer service and reliability; (3) improve APS financial strength consistent with the ability to finance new base load additions; (4) maintain Arizona's energy independence; (5) support the investment necessary to improve efficiency and manage costs; and (6) minimize the impact of price increases by implementing such rates coincident with the change to winter rates in November and reducing the increase in permanent rates determined in the Company's base rate request by a like amount.¹⁵

¹⁵ Ex. APS-11 at 12.

1 APS states that established authorities and Commission precedent interpret the Arizona
 2 Constitution to give the Commission broad power to tailor and implement rates appropriate for
 3 utilities' specific circumstances. As support, APS points to Article 15, § 3 of the Arizona
 4 Constitution, granting the Commission "full power to . . . prescribe just and reasonable classifications
 5 to be used and just and reasonable rate and charges," and Arizona Attorney General Opinion No. 71-
 6 17, providing that "the Commission's powers are not limited to those expressly granted by the
 7 Constitution; the Commission may exercise all powers necessary or essential in the performance of
 8 its duties."¹⁶

9 APS asserts that under Arizona law, the Commission does not need to make a determination
 10 of "emergency" to grant interim relief as requested in its Motion. APS relies primarily on *Pueblo Del*
 11 *Sol Water Co. v. Ariz. Corp. Comm'n*, 160 Ariz. 285, 772 P.2d 1138 (Ariz. Ct. App. 1988) ("*Pueblo*
 12 *Del Sol*"); *Ariz. Corp. Comm'n v. Mountain States Tel. & Tel. Co.*, 71 Ariz. 404, 228 P.2d 749 (Ariz.
 13 1951) ("*Mountain States*"); and Arizona Attorney General Opinion No. 71-17 ("Attorney General
 14 Opinion") as the basis for its position.

15 *Pueblo Del Sol* is a 1988 opinion from the Court of Appeals, Division 2, and is cited by APS
 16 as an example where an Arizona court held that the Commission could grant interim rates without
 17 making a finding of an emergency.¹⁷ In *Pueblo Del Sol*, the Court of Appeals stated that "[i]nterim
 18 rates are not limited to emergency as appellant contends."¹⁸ APS also cites a 1951 Arizona Supreme
 19 Court decision, *Mountain States*, stating that it "upheld a utility's right to interim relief where the
 20 Commission's normal ratemaking process would not be completed in a reasonable time."¹⁹

21
 22 ¹⁶ Op. Att'y Gen. 71-17 at 3 (referencing *Garvey v. Trew*, 64 Ariz. 342, 346, 170 P.2d 845, 847-48 (1946), *cert. denied*,
 329 U.S. 784 (1946)). In *Garvey*, the Arizona Supreme Court stated:

23 The corporation commission is one of the departments of the state government created by the
 24 Constitution. Art. 15, Const. of Arizona; *Phoenix Ry. Co. v. Lount*, 21 Ariz. 289, 187 P. 933. It
 25 has very broad powers conferred upon it by the Constitution.... Nor are the powers of the
 26 commission limited to those expressly granted. We have held that the powers conferred by the
 27 article are merely the minimum, and that under the constitution, the commission may exercise all
 28 powers which may be necessary or essential in connection with the performance of its duties.

Garvey, 64 Ariz. at 346.

¹⁷ In its Initial Post-Hearing Brief, APS acknowledged that there is a more recent, conflicting opinion from the Arizona
 Court of Appeals, Division 1, holding that an emergency is required to grant interim rates, but stated that even under that
 standard, it would be entitled to relief. APS Initial Post-Hearing Brief at 6, note 2.

¹⁸ *Pueblo Del Sol*, 160 Ariz. at 287, 772 P.2d at 1140.

¹⁹ APS Initial Post-Hearing Brief at 6.

1 APS disagrees with Staff's and RUCO's positions that a finding of an emergency is
 2 necessary to implement interim rates. APS argues that the Attorney General Opinion does not clearly
 3 require a finding of an actual emergency when an evidentiary hearing has been held and does not give
 4 an exclusive list of emergency situations. APS cites Wisconsin and Alaska regulatory decisions to
 5 support its claim that other jurisdictions use interim rates or other mechanisms routinely, without first
 6 finding an emergency, and "often based on concerns about a utility's continuing financial viability."²⁰
 7 In response to the statement in the Attorney General Opinion that interim rates are "not proper merely
 8 because a company's rate of return has, over a period of time, deteriorated to the point that it is
 9 unreasonably low,"²¹ APS points to the immediately following sentence which states "[i]n other
 10 words, interim rate relief should not be made available to enable a public service corporation to
 11 ignore its obligations to be aware of its earnings position at all times and to make timely application
 12 for rate relief, thus preserving its ability to render adequate service and to pay a reasonable return to
 13 its investors."²²

14 If the Commission determines that a finding of emergency is required, APS argues, the
 15 Commission has broad authority to consider the circumstances and is not bound by the events
 16 described in the Attorney General Opinion. APS discusses past Commission decisions and decisions
 17 from other jurisdictions in which APS believes that poor earnings, financial difficulties, and threats of
 18 a rating downgrade were reasons to implement interim rates.

19 Finally, APS argues that although the Attorney General Opinion made it clear that it was not
 20 necessary for the Commission to establish the fair value of APS' property to grant interim rate relief,
 21 the Commission could make such a temporary or interim fair value finding here. APS relies on the
 22 following statement in the Attorney General Opinion to conclude that "interim rate relief is always
 23 available to the Commission where, as here, financial difficulties and effective ratemaking dictate
 24 that it be implemented".²³

25 The Commission's broad and exclusive legislative power to choose the modes
 26 by which it establishes rates . . . 'should be construed broadly enough to permit

27 ²⁰ *Id.* at 7.

28 ²¹ Op. Att'y Gen. 71-17 at 20.

²² *Id.*

²³ APS Post-Hearing Reply Brief at 5.

1 the Commission to avail itself of concepts and procedures which are devised
2 from time to time to permit effective utility regulation and to keep pace with
3 constantly changing economic and social conditions”²⁴

3 Mesquite's Position

4 Mesquite recommends that the Commission approve the interim relief requested by APS,
5 subject to refund. Citing testimony by APS' witness, Dr. Ciccetti, Mesquite states that the
6 Commission should carefully consider the long-term interests of the ratepayers. Mesquite notes that
7 the parties agree that a downgrade would result in “(i) reduced access to and increased cost of capital,
8 (ii) reduced operating flexibility in dealing with suppliers and vendors, and (iii) a prolonged passage
9 of time before an investment grade quality credit rating status could be regained, if ever.”²⁵

10 Mesquite argues that the Commission has the requisite jurisdiction and authority to grant
11 interim relief, citing the Attorney General Opinion and previous Commission decisions. Mesquite
12 argues that the Attorney General Opinion says that a ratepayer does not have a right to notice and an
13 opportunity to be heard when an interim rate request involves a situation of “true emergency,” but
14 that such rights may exist in “non-emergency” situations. From this Attorney General Opinion
15 discussion of notice and intervention rights during interim rate proceedings, Mesquite concludes that
16 because intervention was granted in this proceeding and a hearing was held, no demonstration of a
17 financial emergency is required for interim rates to be implemented.²⁶ Mesquite states that, pursuant
18 to the Attorney General Opinion, the Commission is not required to make a fair value determination
19 in order to set interim rates and that prior Commission decisions from the 1970s and 1980s²⁷ granted
20 APS interim rate relief without finding an emergency. Mesquite concludes that there is legal
21 jurisdiction and authority, as well as ample precedent, for the Commission to grant interim rate relief
22 as requested by APS.

23 AIC's Position

24 AIC recommends that the Commission approve the interim relief requested by APS. AIC
25 believes that although the request was needed at the time of the Motion due to APS' construction
26

27 ²⁴ *Id.* at 4, (quoting Op. Att'y Gen. 71-15 (use of automatic adjustment clauses)).

²⁵ Mesquite's Closing Brief at 6.

²⁶ *Id.* at 3.

28 ²⁷ Mesquite cited Decision No. 48569 (January 4, 1978) and Decision No. 55228 (October 9, 1986).

1 budget and need to maintain its FFO/Debt ratio at a level supporting an investment grade credit
 2 rating, "the unprecedented economic developments immediately preceding, during and since the
 3 hearing have amplified by several times the need to place APS on a stronger financial footing."²⁸ AIC
 4 argues that a downgrade to junk would not only result in higher costs to ratepayers, but would impair
 5 APS' ability to finance needed generation facilities. Although APS' current ratings are "stable," AIC
 6 argues that indications have been made in recent reports that deterioration in cash flows or a
 7 "sustained weakening of financial metrics" could result in a downgrade.²⁹

8 AIC relies upon Article 15, § 3 of the Arizona Constitution, *Mountain States*, the Attorney
 9 General Opinion; and a 1949 California Public Utilities Commission ("PUC") decision³⁰ cited in the
 10 Attorney General Opinion; and six interim rate decisions issued by the Commission during 1975-
 11 1986. AIC argues that the "ability to grant interim relief to APS is essentially an authority 'sub-set'
 12 of the Commission's broader 'full power' to prescribe rates and charges"³¹ as set forth in Article 15,
 13 § 3 of the Arizona Constitution. AIC quotes the California PUC's finding of implicit authority to
 14 grant interim rate increases:

15 It is an elementary rule of law that the power to grant a particular relief carries
 16 with it all the incidental, necessary, and reasonable authority to grant that which is
 17 less. It is apparent that the authority delegated to this Commission by the Public
 18 Utilities Act to award rate relief to a public utility carries with it the incidental and
 19 implied power to grant interim rate relief, if the facts warrant such summary
 relief."³²

20 AIC concludes that because the Arizona Constitution grants the Commission "full power," the
 21 Commission has the necessary "lesser" authority to grant interim relief, and the focus should be on
 22 whether the "facts warrant such summary relief." AIC disagrees with RUCO's position that the
 23 "emergency" exception should be narrowly construed. AIC also argues that although the procedural
 24 posture of APS' request differs from the situation in *Mountain States*, "the basic proposition
 25

26 ²⁸ AIC Opening Brief at 2.

27 ²⁹ *Id.* at 7.

³⁰ *Pacific Tel. & Tel. Co.*, 78 P.U.R. (N.S.) 491, (1949).

³¹ AIC Opening Brief at 7.

28 ³² *Id.* at 8, citing *Pacific Tel. & Tel. Co.*, 78 P.U.R. at 493.

1 established by the Supreme Court has equal application here,” where the Commission is unable to
2 “grant relief in a reasonable time.”³³

3 **AECC’s Position**

4 AECC is supportive of interim rate relief because it agrees with APS that it is not in APS’ or
5 its ratepayers’ best interest for APS to be threatened with a credit downgrade to below investment
6 grade. AECC disagrees with the level of interim rate relief requested by APS, based upon an analysis
7 conducted by AECC witness Kevin Higgins. Mr. Higgins testified that AECC’s recommendation is
8 intended to preserve APS’ financial health while the permanent rate case is pending. He determined
9 that a \$42.4 million increase in interim rates would be sufficient to avoid the threat of a downgrade
10 and would allow APS to maintain an FFO/Debt ratio of 18.25 percent until the pending permanent
11 rate case is resolved. Mr. Higgins testified that an 18.25 percent FFO/Debt ratio is within the
12 investment grade range.³⁴ Mr. Higgins also testified that given the growth in Arizona and the need
13 for additional infrastructure, there will be a need for new equity. Although he acknowledged that if
14 the new equity is delayed or not issued, it would take a rate increase of more than \$42.4 million to
15 achieve an 18.25 percent FFO/Debt ratio, Mr. Higgins did not alter the amount of his recommended
16 interim rate relief:

17
18 And I want to be clear that I am not recommending more than \$42.4 million. I
19 do believe that APS should have the latitude to decide when the most propitious
20 moment is for the company to infuse that equity and to go to the capital markets
21 for additional equity. . . my recommendation is that it ought to be left to them to
22 weigh those factors going forward and to act in the best financial interest of the
23 company, and therefore, customers with respect to issuing that new equity.³⁵

24 AECC points out that APS Exhibit 9, “APS’ 12/31/1009 Projected FFO to Debt Ratio” does
25 not show the effects of Mr. Higgins’ recommended \$42.4 million interim increase with the APS \$500
26 million reduction in capital expenditures. According to AECC, even if the \$400 million equity
27 infusion is not made, APS’ FFO/Debt ratio at the end of 2009 would be about 18.76 percent after the

28 ³³ AIC Opening Brief at 8.

³⁴ Ex. AECC-1 at 6.

³⁵ Tr. at 269.

capital reduction and the AECC \$42.4 interim rate increase.³⁶ In response to Staff's "alternative recommendation," AECC states that "[u]nfortunately in this scenario, the interim increase would be based on factors that AECC contends should be more fully addressed in the general rate case proceeding."³⁷

AECC recommends that if the Commission grants an interim rate increase, it be applied on an equal-percentage basis across the customer classes subject to the increase. Mr. Higgins explained that it is a fundamental rate design objective for the cost recovery mechanism to reflect the general nature of the costs being recovered and that other regulatory jurisdictions use a rate design method similar to AECC's proposal when implementing interim rate increases. Mr. Higgins testified that no Class Cost of Service Study was conducted for purposes of the Motion and that, because the need for the increase is related to rate base and not fuel and purchased power costs, there is no basis to apply an interim rate increase for base rates on an energy charge. Although AECC agreed with Staff that the appropriate rate design is a public policy determination to be made by the Commission, it disagreed with Staff's and RUCO's preferred rate design, arguing that there is no sound basis to allocate the increase on energy charges and that such an approach would be unjust and unreasonable for higher-load and higher-voltage customers, whether they be commercial or residential.³⁸

AECC also asserts that the Commission has authority to grant interim rates, citing the Attorney General Opinion and *Mountain States*. According to AECC, the Attorney General identified two situations when interim rates could be authorized: (1) "as an emergency measure when sudden change brings hardship to a company, when the company is insolvent, or when the condition of the company is such that its ability to maintain service pending a formal rate determination is in serious doubt,"³⁹ and (2) when the Commission is unable to "grant permanent rate relief within a reasonable time."⁴⁰ According to AECC, because a demonstration of "emergency" is not required under the second situation, "it stands to reason that a showing of 'emergency' is not a legal

³⁶ AECC Reply Brief at 3.

³⁷ *Id.* at 5.

³⁸ AECC Post-Hearing Brief at 11-12; Ex. AECC-1 at 8 ("For example, at the amount of interim increase proposed by APS, a 75 percent load factor E-35 customer would experience a base rate increase in excess of 7.7 percent under a flat kWh charge – 75 percent higher than the 4.4 percent average increase identified by Mr. Rumolo.").

³⁹ Op. Att'y Gen. 71-17 at 20.

⁴⁰ *Id.*

1 requirement that would otherwise prohibit the Commission from granting an interim rate increase
2 when the public interest demands it.”⁴¹ AECC concludes that if the Commission decides to grant
3 interim rates only upon a finding of an emergency, then it makes that requirement as a matter of
4 public policy, because neither the Arizona Constitution nor other state law imposes such a
5 requirement.

6 **RUCO’s Position**

7 RUCO recommends that the Commission deny APS’ Motion for interim rates. Stephen
8 Ahearn, Director of RUCO, testified that [APS’ claim that] “interim rates are necessary to mitigate
9 ‘timing differences’ that arise as a result of the lag between the plant construction period and the time
10 when the plant enters service and is included in rates”⁴² does not constitute an emergency under
11 Arizona law. Mr. Ahearn explained that the “timing differences” are a normal part of the regulatory
12 process and that they work both ways, tending to offset the effects. Mr. Ahearn believes that:

13
14 This APS request is yet another example of how Arizona utilities are attempting
15 to redefine the regulatory paradigm in Arizona, which has worked fairly and
16 rationally for decades. Utilities, through requests for automatic adjusters,
17 interim/emergency rates, single issue ratemaking, decoupling mechanisms, and
18 ‘ACRM-like’ mechanisms would like to create a new regulatory system that shifts
19 the risk from their shareholders to their ratepayers. Consideration of these types
20 of schemes is a very slippery slope that could easily lead to a situation where
21 monopoly enterprises could operate in the absence of any effective or meaningful
22 regulation.

23 Moreover, requests for these types of schemes have become the norm and not the
24 exception Extraordinary relief, if ever, should only be allowed in
25 extraordinary situations. The Commission should not allow non-traditional
26 ratemaking practices to become the norm.⁴³

27 RUCO argues that the record does not support a conclusion that APS will be downgraded if
28 the Commission does not grant interim relief, as only one credit rating agency is even considering a
29 downgrade.⁴⁴ RUCO argues that the emergency exception should be narrowly construed and that the
30 Commission should not find an emergency exists based upon speculation about rating agencies’
31 future actions. If the Commission were to consider APS’ claims about the credit rating agencies,

32 ⁴¹ AECC Post-Hearing Brief at 14.

33 ⁴² Ex. RUCO-4 at 5.

34 ⁴³ *Id.* at 6-7.

35 ⁴⁴ RUCO Post-Hearing Brief at 2.

1 RUCO notes, it is not clear that a downgrade is imminent because only one rating agency has APS at
 2 the lowest investment grade and another just upgraded APS' outlook to "stable," the FFO/Debt ratio
 3 is only one financial metric used by rating agencies, and the FFO/Debt projections do not show a
 4 decrease to below 18 percent if the interim relief is not granted.⁴⁵

5 RUCO also argues that the specific amount requested, \$115 million, is "not supported by the
 6 record and is arbitrary."⁴⁶ RUCO finds APS' rationale, that the amount would minimize the impact
 7 on ratepayers because it would mimic existing rates, to be disrespectful to the Company's customers
 8 who should not have to overpay just to keep rates consistent.⁴⁷ RUCO concludes its Reply Brief by
 9 noting the "great uncertainty" caused by the recent market turmoil and cautioning the Commission to
 10 "take their time to allow a reasonable perspective of recent market events to inform the ultimate
 11 decision in this matter."⁴⁸

12 RUCO argues that exceptions to constitutional requirements such as a fair value finding and
 13 determination of just and reasonable rates should be narrowly construed. According to RUCO,
 14 Arizona courts have recognized limited circumstances when the Constitution's fair value ratemaking
 15 provision is not mandatory: (1) when rates change pursuant to an already established adjustor
 16 mechanism; and (2) when an emergency exists, provided a bond is posted guaranteeing a refund if
 17 necessary once the Commission has considered fair value rate base and made a final determination of
 18 just and reasonable rates. RUCO disagrees with APS' argument that a finding of emergency is not
 19 required in order to approve interim rates, citing the recent Court of Appeals' conclusion in
 20 *Residential Utility Consumer Office v. Ariz. Corp. Comm'n*, 199 Ariz. 588, 20 P.3d 1169 (Ariz. Ct.
 21 App. 2001) ("*RUCO*") that the statement in *Pueblo de Sol* that interim rates are not limited to
 22 emergency situations had "misstated the test set forth in *Scates*."⁴⁹ In *RUCO*, the Court of Appeals
 23 stated that "[c]learly, *Scates* contemplated, and we agree, that interim rate making requires all three
 24 elements – an emergency situation, the posting of a bond, and a subsequent full rate case – in order to

25 ⁴⁵ *Id.* at 7-8.

26 ⁴⁶ RUCO argues that the Commission should "only consider facts that are tangible" and not "verbal representations from
 a third party that have not been authenticated, corroborated or even verified in any legal manner." RUCO Reply Brief at
 27 5.

⁴⁷ *Id.*

⁴⁸ *Id.* at 6.

28 ⁴⁹ *RUCO*, at 199 Ariz. 592, 20 P.3d at 1173.

comport with the constitutional mandate that rates be just and reasonable.”⁵⁰ RUCO recommends that the Commission not use its broad powers to expand the exceptions to the Arizona Constitution’s fair value requirement.

Staff’s Position

Staff recommends that the Commission deny APS’ Motion for interim rates because APS has not established that interim rate relief is warranted. If the Commission were to find that interim rates are appropriate, Staff presented an alternative recommendation.

Ralph Smith, a Senior Regulatory Consultant, testified on behalf of Staff concerning APS’ requested interim rate increase. Mr. Smith testified that APS has not identified any sudden or unanticipated event or circumstance affecting its ability to provide reliable, safe, reasonable, and adequate service while its permanent rate case is being processed; that APS is not facing a financial emergency and continues to obtain financing; and that no downgrade of APS’ credit rating appears imminent or probable while the permanent rate case is pending.⁵¹ He concludes that no emergency exists to support the requested interim rate increase.

Mr. Smith agrees that a downgrade to junk status would not be a desirable outcome, but pointed out that no credit rating agency has stated that APS’ debt would be downgraded if the interim rates were denied by the Commission. Staff believes that an analysis of APS’ financial condition shows that APS’ debt is investment grade; the outlook for APS and Pinnacle West is “stable”; APS’ FFO/Debt ratio is “well within the 15% to 30% range specified by Standard & Poor’s for a BBB-rating for a corporation with a ‘strong’ business risk profile and an ‘aggressive’ financial risk profile and within the 10% to 30% range for a U.S. utility with that business and financial risk profile;”⁵² the FFO/Debt ratio is 23 percent in 2008; and APS and Pinnacle West have Commission authorization to issue \$400 million in equity. Mr. Smith testified that although APS alleges that it is experiencing negative effects from regulatory lag because customer growth is not generating revenues to cover the cost of capital improvements, it is impossible to make such a determination in an interim rate case due to the abbreviated schedule and lack of opportunity to conduct an investigation. He notes that in

⁵⁰ *Id.*

⁵¹ Ex. S-1 at 15-16.

⁵² *Id.* at 29.

1 the previous permanent rate case, Staff's investigation concluded that APS' claim was not supported
2 by the evidence, and in any event, ordinary regulatory lag by itself is not the type of circumstance
3 that justifies interim rates.

4 Mr. Smith explained why regulatory lag is not a reason to implement interim rates:

5
6 Regulatory lag is an ordinary and anticipated feature of regulation. One of the
7 useful functions of regulatory lag is to place financial responsibility upon the
8 utility for fluctuations in costs between rate cases. The regulatory lag feature of
9 Rate Base/Rate of Return regulation is essential to effective and efficient
10 operation of such a regulatory regime. Because of the lag between placing new
11 plant into service and obtaining rate recognition of such plant, the utility may bear
12 the cost of new plant additions temporarily. This can encourage management to
13 emphasize cost control to a higher degree than might be expected if cost
14 responsibility for plant additions during the periods between rate cases were
15 shifted away from the utility and onto ratepayers. In evaluating plant additions,
16 the Company should conduct a cost-benefit analysis to determine if there is a
17 business case for implementing the plant additions on the time frame budgeted by
18 the Company. If the case is compelling and the project is cost-justified, no
19 additional special ratemaking treatment is needed. If the project is not cost-
20 justified or the benefits are too speculative to warrant the commitment of funds, it
21 may be prudent to delay or avoid the related capital expenditures. These
22 incentives that are currently in place would be lessened if ordinary regulatory lag
23 began to be utilized by Arizona utilities as a justification for interim rate
24 increases. Absent some emergency or other exceptional circumstance, ordinary
25 regulatory lag by itself does not warrant the extraordinary relief of an interim rate
26 increase.⁵³

18
19 In the event that the Commission wants to grant an interim rate increase, Staff presented an
20 alternative basis for determining the amount of increase. Mr. Smith testified that given the limited
21 time to review APS' rate request, one way to find an appropriate increase might be to use the
22 increased investment in net plant with the most recently approved cost of capital. Using the most
23 recently approved cost of capital applied to the approximate \$538 million increase in the level of
24 unadjusted jurisdictional rate base proposed in APS' pending rate case over the adjusted level found
25 in Decision No. 69663, Staff calculates an increase of \$65.2 million in interim rates. Although
26 initially Staff recommended that this \$65.2 million increase be contingent upon APS receiving the
27

28 ⁵³ *Id.* at 12-13.

1 \$400 million equity infusion from Pinnacle West, at the hearing, Staff modified its recommendation
2 to eliminate that contingency. Staff recommended that if the Commission decided to implement
3 interim rates, the rate design should be simple and straight-forward to implement and the revenues
4 should be tracked, verified and easy to refund.

5 David Parcell, Consulting Economist, also testified on behalf of Staff concerning APS'
6 requested interim rate increase. Mr. Parcell testified that although APS focuses on a single financial
7 metric (FFO/Debt), rating agencies indicate that many factors go into the ratings process, that all
8 rating agencies rate APS as "stable,"⁵⁴ and only one of the three major rating agencies has APS at the
9 lowest investment grade. Mr. Parcel used other indicators of financial strength and viability to
10 compare APS with other electric utilities and found the stock rankings of Pinnacle West are typically
11 in the above-average categories for electric utilities, indicating below-average risk. He concludes that
12 APS is not presently at any significant risk of a downgrade.

13 Staff disagrees with APS' claim that interim relief is possible on a "somewhat routine
14 basis,"⁵⁵ but also disagrees with RUCO that the Commission can only set interim rates in emergency
15 situations. Staff believes that the Commission can order interim rates if it believes the record
16 supports a finding that an emergency is likely to occur and makes some finding of fair value in the
17 decision granting interim rates. According to Staff, it is reasonable that the Commission would:

18 . . . have some ability to act to avert an impending crisis, as long as it finds some
19 measure of fair value. The plenary and exclusive Constitutional authority of the
20 Commission over rates would seem to necessarily encompass the ability to act to
21 prevent an emergency from occurring as much as it encompasses the ability to
22 alleviate an emergency that is in the process of occurring or has occurred.⁵⁶

23 Staff also cited the Attorney General Opinion statement that the Commission's power to
24 choose the methods used to establish rates should be broadly construed to allow the Commission to
25 use the concepts and procedures it deems necessary for effective utility regulation as economic and
26 social conditions change. Staff also notes that the Attorney General Opinion recognizes the

27 ⁵⁴ Moody's recently (July 2008) revised APS' outlook from negative to stable. Ex. S-2 at 11.

28 ⁵⁵ Staff Reply Brief at 2.

⁵⁶ Staff Initial Post-Hearing Brief at 8.

1 *Mountain States* exception to the need to find fair value when the Commission is unable to grant
 2 permanent rate relief in a reasonable time. Although Staff agrees with APS' characterization that the
 3 Commission "may exercise all powers necessary or essential in the performance of its duties,"⁵⁷ Staff
 4 believes that APS' position would allow interim rate relief at almost any time, an extreme view with
 5 which Staff disagrees. Staff argues that interim rate relief is "intended for extraordinary, unusual, or
 6 exigent circumstances," citing *RUCO* and the Attorney General Opinion. Staff states:

7
 8 It is not, as APS would apparently prefer, a means to accomplish early rate relief
 9 for rate base additions or for perceived shortfalls in equity returns. Interim rate
 10 relief should be viewed as an extraordinary remedy because interim rate
 11 proceedings are expedited and therefore lack the extended opportunities for
 12 discovery and audit that are normally associated with Commission rate cases.
 Because both the time and the means for processing and evaluating interim rate
 cases are abbreviated, an interim rate case is not the most thorough or complete
 means for setting rates. Such procedures should therefore be used sparingly, as
 the exception instead of the rule.⁵⁸

13 Staff notes that *RUCO* did not address the issue of what authority the Commission has to set
 14 interim rates if it also makes a fair value finding. Staff is concerned that *RUCO*'s position may
 15 "significantly restrict the Commission's ability to act in an impending emergency."⁵⁹ Staff argues
 16 that while the Commission's authority to grant interim rates is "probably not limited to circumstances
 17 that present an ongoing emergency, interim rates should nonetheless be regarded as an extraordinary
 18 form of rate relief, available only in connection with urgent, unusual, or special circumstances."⁶⁰
 19 Staff believes that if an emergency has already occurred or is occurring, the law does not require a
 20 fair value finding be made to implement interim rates. However, Staff recommends that if an
 21 emergency is not present, the Commission make a fair value finding if it grants interim rates.⁶¹

22 ANALYSIS

23 The Commission's authority to grant a utility emergency rate relief is part of its constitutional
 24 ratemaking authority, which has been construed as plenary and exclusive. Ariz. Const. art. 15 § 3;
 25

26 ⁵⁷ Staff Post-Hearing Reply Brief at 2.

27 ⁵⁸ *Id.*

⁵⁹ *Id.* at 3.

⁶⁰ *Id.*

28 ⁶¹ *Id.*

1 *Arizona Corp. Comm'n v. State ex rel. Woods*, 171 Ariz. 286, 830 P.2d 807 (Sup. Ct. 1992); *State v.*
 2 *Tucson Elec. Light and Power Co.*, 15 Ariz. 294, 138 P. 781 (Sup. Ct. 1914).⁶²

3 In May of 1971, upon the request of the Commission's Chairman, Russell Williams, the
 4 Arizona Attorney General issued Opinion No. 71-17. Therein, it is explained that interim rates are
 5 used to:

6 fill a hiatus which occurs between the time that existing rates being charged by a
 7 public service corporation have been invalidated by a court or have been
 8 determined by the appropriate regulatory body to be confiscatory of the
 9 corporation's property, and the time that permanent rates which produce a fair
 return are established.⁶³

10 The Attorney General Opinion discusses criteria used to determine whether an emergency
 11 exists and when interim rates are appropriate:
 12

13 The foregoing authorities make it clear that, in general, courts and
 14 regulatory bodies utilize interim rates as an emergency measure when sudden
 15 change brings hardship to a company, when a company is insolvent, or when the
 condition of the company is such that its ability to maintain service pending a
 formal rate determination is in serious doubt.

16 In addition, under the *Mountain States Telephone* case, *supra*, the inability
 17 of the Commission to grant permanent rate relief within a reasonable time would
 be grounds for granting interim relief.

18 Perhaps the only valid generalization on this subject is that interim rate
 19 relief is not proper merely because a company's rate of return has, over a period
 20 of time, deteriorated to the point that it is unreasonably low. In other words,
 21 interim rate relief should not be made available to enable a public service
 corporation to ignore its obligations to be aware of its earnings position at all
 times and to make timely application for rate relief, thus preserving its ability to
 render adequate service and to pay a reasonable return to its investors.

22
 23 In *Scates v. Arizona Corp. Comm'n*, 118 Ariz. 531, 578 P.2d 612 (Ariz. Ct. App. 1978)
 24 ("*Scates*"), the Court of Appeals, Division 1, held that the Commission did not have authority to
 25 increase rates for select services without making a determination of the utility's investment and how

26
 27 ⁶² While the state legislature may enlarge the Commission's powers pursuant to Article 15, § 6, it cannot limit that
 constitutional power. The Commission's "exclusive field may not be invaded by either the courts, the legislative, or
 executive." *Tucson Elec.*, 15 Ariz. at 306, 138 P. at 786.

28 ⁶³ Op. Att'y Gen. 71-17 at 1-2.

1 the substantial increase would affect the utility's rate of return on that investment. The *Scates* Court
2 stated:

3
4 Although all parties before the Commission generally agreed that it would be
5 improper to implement an increase of all rates without such inquiry, we see no
6 justification for permitting the same increase in revenues to be accomplished by
7 raising only some of the tariffs. As special counsel for the Commission's staff
8 pointed out during the course of this hearing, such a piecemeal approach is
fraught with potential abuse. Such practice must inevitably serve both as an
incentive for utilities to seek rate increases each time costs in a particular area
rise, and as a disincentive for achieving countervailing economies in the same or
other areas of their operations.⁶⁴

9 In its decision, the Court also discussed the Attorney General Opinion and the limited
10 circumstances where interim rates should be used to those:

11
12 where an emergency exists, where a bond is posted guaranteeing a refund to the
13 utility's subscribers if any payments are made in excess of the rates eventually
14 determined by the Commission, and where a final determination of just and
reasonable rates is to be made by the Commission after it values a utility's
property.⁶⁵

15
16 The *Scates* Court found that the Commission's decision to increase rates did not fit under either the
17 interim rate or automatic adjustment exception to the Constitution's requirement of a fair value
18 finding.

19 In *Pueblo Del Sol*, the Court of Appeals, Division 2, decided the issue of whether the
20 Commission had the power to implement "interim rates" when it approved the transfer of assets and
21 Certificate of Convenience and Necessity ("CC&N") from one water utility to another and required
22 the purchasing utility to charge the (higher) rates of the selling utility, subject to refund. The Court
23 stated:

24 Interim rates are not limited to emergency situations as appellant contends. In
25 fact, when previous rates are confiscatory the courts are authorized to allow the
26 utility to impose its own increased rates on an interim basis until the Commission
imposes reasonable rates. *Arizona Corporation Commission v. Mountain States*

27
28 ⁶⁴ *Scates*, 118 Ariz. At 535, 578 P.2d at 616.

⁶⁵ *Id.*

1 *Tel. & Tel. Co.*, 71 Ariz. 404, 228 P.2d 749 (1951). Although there is no Arizona
 2 authority on the Commission's power to impose interim rates subject to a
 3 decrease, it is only logical that they can do so. *United Tel. Co. of Florida v.*
 4 *Mann*, 403 So.2d 962 (Fla.1981). Appellant would have the Commission's power
 5 limited to imposing interim rates that are only subject to increases. It appears that
 6 appellant wants to have its cake and eat it too. We cannot condone such a result.⁶⁶

7 In *RUCO*, a water utility filed a request for a surcharge to collect increased costs it was
 8 paying for water from the Central Arizona Project ("CAP"). The Commission found that the utility's
 9 rate of return was less than its authorized rate of return, but that the utility had not demonstrated that
 10 the deterioration in its rate of return was caused by the increase in its CAP water expenses. The
 11 Commission also found that the utility's operations had changed significantly since its last rate case,
 12 with a 49 percent increase in customers, a 300 percent increase in rate base, and a 57 percent increase
 13 in revenues. Because these factors could affect rates and needed to be analyzed during a full rate
 14 hearing, the Commission required the utility to file a rate application within six months and granted
 15 the surcharge subject to "true-up" at a full rate hearing. On appeal, the Commission argued that its
 16 decision was lawfully based on its "constitutionally sanctioned plenary power to prescribe rates"⁶⁷
 17 and not on an emergency basis, relying on the *Pueblo Del Sol* decision and a liberal interpretation of
 18 *Scates*.⁶⁸

19 In determining whether the Commission exceeded its constitutional rate-making authority by
 20 approving a surcharge without first conducting a fair valuation of the utility's property and
 21 determining its rate base, the Court of Appeals, Division 1, summarized the law in Arizona
 22 concerning the Commission's interim ratemaking authority:

23 Although the Commission's authority to prescribe rates is plenary, *Tucson*
 24 *Elec. Power Co.*, 132 Ariz. at 242, 645 P.2d at 233, the Commission's rate-
 25 making authority is subject to the "just and reasonable" clauses of Article 15,
 26 Section 3 of the Arizona Constitution. Under most circumstances, the
 27 Commission is constitutionally obligated

28 to find the fair value of the [utility's] property and use such finding as a
 rate base for the purpose of calculating what are *just and reasonable*

⁶⁶ *Pueblo Del Sol*, 160 Ariz. at 287, 772 P.2d at 1140.

⁶⁷ *RUCO* at 590, 1171.

⁶⁸ *RUCO* at 592, 1173.

1 rates While our constitution does not establish a formula for
 2 arriving at fair value, it does require such value to be found and used as
 3 the base in fixing rate. *The reasonableness and justness of the rates*
 4 *must be related to this finding of fair value.*

5 *Simms*, 80 Ariz. at 151, 294 P.2d at 382 (emphasis added); *see also Arizona*
 6 *Corp. Comm'n v. Ariz. Pub. Serv. Co.*, 113 Ariz. 368, 370, 555 P.2d 326, 328
 7 (1976); Ariz. Const. art. 15, § 14. In limited circumstances, the Commission
 8 may engage in rate making without ascertaining a utility's rate base. The
 9 Commission can exercise its authority when rates are predicated on an interim
 10 basis or when the rate changes are pursuant to an automatic adjustment clause.

11 Relying on the supreme court's decision in *Arizona Corporation*
 12 *Commission v. Mountain State Telephone & Telegraph Co.*, 71 Ariz. 404, 228
 13 P.2d 749 (1951), the Arizona Attorney General acknowledged that the superior
 14 court has the authority to order a temporary rate increase without a full rate
 15 hearing. Op. Att'y Gen. 71-17 at 10. The Attorney General reasoned that the
 16 Commission itself could approve rate increases without first determining the fair
 17 value of the utility's property, but "only upon a finding that an emergency
 18 exists." *Id.* *Scates* follows the Attorney General's conclusion that, while the
 19 Commission has broad authority when setting rates, the interim rate-making
 20 authority is limited to circumstances in which (1) an emergency exists; (2) a
 21 bond is posted by the utility guaranteeing a refund to customers if the interim
 22 rates paid are higher than the final rates determined by the Commission; and (3)
 23 the Commission undertakes to determine final rates after a valuation of the
 24 utility's property. 118 Ariz. at 535, 578 P.2d at 616 (following the conclusion
 25 drawn in Op. Att'y Gen. 71-17).⁶⁹

26 The Court in *RUCO* discussed the *Pueblo Del Sol* decision, stating that:

27 Although depicted as an "interim rate," the rate that was being charged by the
 28 selling utility was a final rate set by the Commission for that particular company.
Id. at 286-87, 772 P.2d at 1139-40. We do not believe *Pueblo Del Sol* to be an
 "interim rate" case as contemplated by *Scates*. The Commission's approval in
Pueblo Del Sol was, in effect, an approval of the continued use of a previously
 authorized rate.

When discussing interim rates, the *Pueblo Del Sol* court restated the test set
 forth in *Scates* in the disjunctive. The court defined interim rates as "rates charged
 by the utility for services or products pending the establishment of a permanent
 rate, in emergency situations, or where a bond is posted that guarantees a refund
 to consumers for any excess paid by them prior to the Commission's final
 determination." *Id.* at 287, 772 P.2d at 1140 (emphasis added). Although we
 agree with the result reached in *Pueblo Del Sol*, we believe that the court
 misstated the test set forth in *Scates*. We agree with the *Scates* court's approval
 of the circumstances in which interim rates may be considered and approved by
 the Commission. Clearly, *Scates* contemplated, and we agree, that interim rate

⁶⁹ *RUCO*, 199 Ariz. at 591, 20 P.3d at 1172.

1 making requires all three elements-an emergency situation, the posting of a bond,
2 and a subsequent full rate case-in order to comport with the constitutional
3 mandate that rates be just and reasonable.⁷⁰

4 As the parties have set forth in their legal briefs, the Commission has broad and exclusive
5 ratemaking authority under the Constitution. However, the Constitution itself imposes requirements
6 associated with that ratemaking power. Article 15, § 14, provides that the Commission "shall, to aid
7 it in the proper discharge of its duties, ascertain the fair value of the property within the state of every
8 public service corporation doing business therein." As discussed above, several Arizona cases and
9 Arizona Attorney General Opinions have discussed the limited situations in which that constitutional
10 fair value finding is not required to be contemporaneous with the adoption and implementation of
11 new rates.

12 Given that the requirement of a fair value finding (which protects both the utility and the
13 ratepayer) is contained in the Arizona Constitution, we believe that, appropriately, the law has
14 developed to allow only limited exceptions to that requirement. Based upon the current law, there are
15 three recognized exceptions to the constitutional fair value finding requirement:

16 (1) emergency rates are lawful when sudden change brings hardship to the utility, when the
17 utility is insolvent, or when the condition of the utility is such that its ability to maintain service
18 pending a formal rate determination is in serious doubt. The utility must post a bond and the
19 Commission must subsequently make a determination of fair value and establish final rates that are
20 just and reasonable.

21 (2) interim rates are lawful when a court or the Commission has made a determination that a
22 utility's existing rates do not provide a fair and reasonable return on the company's property and
23 result in the confiscation of the company's property, and the Commission is unable to grant
24 permanent rate relief within a reasonable time. The utility must post a bond and the Commission
25 must subsequently make a determination of fair value and establish final rates that are just and
26 reasonable.

27 (3) rate changes without a fair value finding are lawful when a previously authorized adjustor
28

⁷⁰ *RUCO*, 199 Ariz. at 592, 20 P.3d at 1173.

1 mechanism is modified outside of a general rate case.⁷¹

2 For the reasons set forth herein, we decline to adopt a new exception to the constitutional fair
3 value finding requirement.

4 Although APS relies on the *Pueblo Del Sol* decision as support for its position that a finding
5 of an emergency is not necessary to implement interim rates, the Court of Appeals, Division 1, in the
6 subsequent *RUCO* decision stated that the court⁷² in *Pueblo Del Sol* had misstated the *Scates* test and
7 that *Scates* required all three elements for interim ratemaking – “an emergency situation, the posting
8 of a bond, and a subsequent full rate case - in order to comport with the constitutional mandate that
9 rates be just and reasonable.”⁷³

10 APS argues that RUCO’s “‘fair value’ argument ignores the nature and purpose of an interim
11 rate” and asserts that a fair value finding is not necessary “because interim rates will eventually
12 become a part of a permanent rate increase or be refunded to ratepayers with interest following a fair
13 value determination made after full examination of all relevant data in the permanent rate case.”⁷⁴
14 Although this logic sounds appealing, it ignores the underlying reason why the Constitution requires
15 a fair value finding that must be related to just and reasonable rates. Utility ratemaking begins with
16 an analysis of the cost of providing service and ends with rates that are designed to collect the
17 appropriate costs and allow the utility the opportunity to earn a reasonable return on the fair value of
18 its property necessary to provide that service. All elements that go into the ratemaking formula to set
19 just and reasonable rates have a temporal quality. Once a representative test year’s operating costs,
20 revenues, and fair value are analyzed, verified, audited and determined to be prudently incurred and
21 properly matched⁷⁵ in a rate case proceeding, just and reasonable rates are set by the Commission. To
22 later modify the rates by changing only one input to that balanced, properly matched ratemaking
23 formula undermines the ongoing justness and reasonableness of the rates, because the rates are no

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25 ⁷¹ We agree with the *RUCO* court that the rates at issue in *Pueblo Del Sol* were not “interim rates” within the context of
the *Scates* analysis.

26 ⁷² Court of Appeals, Division 2.

⁷³ *RUCO*, 199 Ariz. at 592, 20 P.2d at 1173.

27 ⁷⁴ APS Post-Hearing Reply Brief at 4.

28 ⁷⁵ “Matched” means that the expenses and revenues are reflective of the same time period – in order to provide service to
a customer, the utility incurs a specific cost, and therefore must collect a specific amount of revenue. The test-year
establishes the relationship between the cost of providing service and the revenue needed to collect those costs.

1 longer related to the fair value as required by the Constitution.

2 Although APS claims that no harm is done to ratepayers because the rates will be examined
3 later in a permanent rate case, the selective use of interim rates to speed recovery of and on plant
4 investment is not fair from a ratepayer perspective. This is exemplified in the following two
5 examples: First, after rates are established by the Commission in a permanent rate case, over time,
6 some of the utility's individual operating expenses may increase, while others may decrease. To the
7 extent that there is a net decrease in operating expenses, a utility will "overearn" (revenue remains the
8 same but expenses decrease, resulting in greater earnings), earning more than the rate of return used
9 to set rates. The ratepayer continues to pay the previously established rates, and the utility is not
10 obligated to refund the "over-earning" in a permanent rate case.⁷⁶ Second, even if operating expenses
11 do not change, a utility may "overearn" if it does not continue to invest in plant. For example, in a
12 permanent rate case, operating income is established partly on the net plant value at the end of the test
13 year. The value of net plant continues to decrease as depreciation expense is incurred and recovered
14 as a component of existing permanent rates. However, the operating income provision for net plant
15 stays the same until the next rate case determination. The ratepayer continues to pay the previously
16 established rates and the utility is not obligated to refund the "over-earning" in a permanent rate case.
17 Further, to the extent that a plant asset becomes fully depreciated between rate cases, the utility may
18 continue to collect depreciation expense on a fully depreciated asset. In these examples, the earnings
19 of the company will have increased, but no "interim rate relief" is available to ratepayers.

20 APS has not articulated why it is fair or appropriate to routinely require ratepayers to pay
21 interim rate increases while permanent rate cases are being processed, but not to require a utility to
22 file for interim rate relief to decrease its rates when it is overearning. As the court in *Pueblo Del Sol*
23 stated, a utility cannot "have its cake and eat it too."⁷⁷ Even if the law were to allow additional
24 opportunities for interim rate relief in non-emergency situations, from a fairness perspective, we find

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26 ⁷⁶ See Op. Att'y Gen. 89-002.

27 ⁷⁷ See *Pueblo Del Sol* 160 Ariz at 287, 772 P.2d at 1140 (disagreeing with appellant's apparent belief that interim rate
28 relief is appropriate only for rate increases). The court noted that any Commission power to implement interim rates
works both ways – not only could the Commission require rate increases, it could require rate decreases, too. It is
doubtful that APS would agree that the Commission could require an interim rate decrease without also making a finding
that rates were excessive or that an emergency existed.

1 that it is not appropriate to create the opportunity to allow APS to seek non-emergency interim rate
2 increases while a general rate case is pending, because there is no concomitant obligation on APS to
3 file a general rate case when it is overearning, thereby not affording ratepayers the same opportunity
4 for interim rate relief that APS seeks for itself.

5 Although Mr. Brandt argues that regulatory lag "institutionalizes economic confiscation of
6 invested capital" we note that the Arizona Supreme Court has previously considered whether the use
7 of the historic test year is unfair or lacking in due process. In *Ariz. Corp. Comm'n v. Arizona Public*
8 *Service Co.*, 113 Ariz. 368, 555 P.2d 326 (Sup. Ct. 1976), APS argued that "'fair value' set by the
9 Commission is prospectively confiscatory because the use of a historic test year produces a rate
10 which is obsolete before it is set."⁷⁸ APS appealed an October 1975 Commission rate decision and
11 during the Superior Court trial, APS' then vice-president and treasure testified in support of APS'
12 position that the Commission's rate decision violated due process because it would result in
13 confiscation of APS' property:

14 He gave a history of the financial difficulties of the Company resulting in a lower
15 rating of the utility's bonds. The witness then pointed out the descending amount
16 of the rate of return on fair value as time progressed. He stated that the rates set by
17 the Commission are confiscatory and will make the financing of the Company's
18 construction program expensive, and if not impossible, at least much more
19 difficult. He further indicated that in confining the testimony and evidence of fair
20 value to the calendar year of 1974 which had been designated as the historic test
21 year, an unfair and illegal result obtained.

22 The witness pointed out that by September 30, 1975 plant additions were over
23 \$71,000,000 and that by year end 1976, plant additions in the amount of
24 \$209,000,000 will be in service. None of this evidence was considered by the
25 Commission in determining the Company's fair-value rate base.⁷⁹

26 The Supreme Court found that the record provided "no evidentiary basis for holding that the
27 rate set by the Commission is at this juncture confiscatory"⁸⁰ noting that if the rate were to become
28 confiscatory in the future, the appropriate relief would be to file a rate application. The Court

⁷⁸ *Ariz. Corp. Comm'n* 113 Ariz. at 328, 555P.2d at 370.

⁷⁹ *Id.* at 327, 369.

⁸⁰ *Id.* at 328, 370.

1 concluded that:

2 Although we might be sympathetic to the problems of a rapidly expanding utility
3 in inflationary times, we are restrained by the provisions of the constitution and
4 our interpretations of that document. The determination of the formula to be used
5 by the Commission falls within their legislative function. Only if the
6 determination of the fair value is arbitrary and unfair at the time it is made, can
7 the courts interfere.⁸¹

8 The Court did not agree with APS that the Commission's use of the historic test year violated
9 due process or resulted in a confiscation of property.⁸²

10 AIC cites previous Commission decisions⁸³ from the 1970's and '80's in which the
11 Commission granted APS interim rates. In those cases, the Commission determined that an
12 emergency existed under the law and authorized interim rates, subject to refund. We also note that in
13 addition to authorizing interim rates those decisions required APS to "pay for an in-depth study of the
14 management and operations of the company . . . selected by the Commission" (Decision No. 44920);
15 required APS to make a filing addressing whether APS' "ongoing construction program is justified
16 for its Arizona customers in light of the most recent load data and forecast available . . . and a
17 detailed explanation of whether, and to what extent if any, APS' management has taken steps to
18 improve its efficiency and effectiveness in response to the management study" (Decision No. 51753);
19 and required APS to cease Allowance for Funds Used During Construction ("AFUDC") on an
20 amount of Construction Work in Progress ("CWIP") associated with the first generating unit of Palo
21 Verde, in order to "prevent any possibility of increased shareholder earnings during the existence of
22 [the] emergency and to compensate APS's ratepayers for the increased value of cash earnings over
23 AFUDC earnings" (Decision No. 53909).

24 APS argues that the Commission authorized interim rate relief for Tucson Electric Power

25 ⁸¹ *Id.* at 328-29, 370-71. (referencing *Simms v. Round Valley Light & Power Co.*, 80 Ariz. 145, 294 P.2d 378 (Sup. Ct. 1956) and *Ariz. Corp. Comm'n v. Arizona Water Co.*, 85 Ariz. 198, 335 P.2d 412 (Sup. Ct. 1959).

26 ⁸² The Supreme Court also disagreed with Attorney General Opinion No. 74-25 and found that the Commission may
27 consider additional plant under construction at the close of the test year as long as the Commission's method complies
28 with the Constitution and is not arbitrary and unreasonable.

⁸³ Decision No. 44920 (January 16, 1975); Decision No. 47359 (September 30, 1978); Decision No. 51753 (February 4, 1981); Decision No. 53349 (December 21, 1982) (Arizona Water Co.); and Decision No. 53909 (January 30, 1984).

1 (“TEP”) without finding the existence of an emergency in Decision No. 69568 (May 21, 2007). On
2 September 12, 2005, TEP filed a Motion to Amend Decision No. 62103 pursuant to A.R.S. § 40-252.
3 In Decision No. 68669 (April 20, 2006) the Commission ordered that a hearing be held pursuant to
4 A.R.S. § 40-252 to consider amending Decision No. 62103 and TEP’s 1999 Settlement Agreement in
5 light of the Commission’s Track A and B Orders and a subsequent court decision concerning electric
6 restructuring. In Decision No. 69568, the Commission determined that, in light of the ongoing
7 dockets and discussions concerning TEP’s rates, no reduction in rates would occur until the
8 permanent rate case, but implemented a mechanism for refund or credit. Decision No. 69568
9 involved an A.R.S. § 40-252 proceeding to amend a previous rate order and, therefore, is
10 distinguishable from this Motion made in a pending rate case.

11 APS’ argument that other jurisdictions use interim rates or other mechanisms routinely to
12 address a utility’s financial viability and AIC’s reference to the California PUC’s finding of implicit
13 authority, ignore the fact that, unlike other states, Arizona has a *constitutional* fair value finding
14 requirement. Although we have broad power to use concepts and procedures that adapt to changing
15 social and economic conditions, we still must comply with the Constitution. APS is encouraged to
16 propose concepts and procedures that it believes will assist us in addressing changing conditions, but
17 they must comply with the Constitution.

18 Although Staff and APS indicate that even if the Commission finds that there is no
19 emergency, the Commission could grant interim rates if it makes a fair value finding as well, we
20 decline to adopt that approach or reach that conclusion in this case. Staff’s alternative position seems
21 designed to find a way to allow interim rates in the event that we believed that an emergency does not
22 currently exist, but might in the near future. We prefer to use our broad discretion to determine what
23 constitutes an “emergency” rather than to create a “mini rate case proceeding” using a temporary fair
24 value finding.⁸⁴ We believe that under certain circumstances, an “emergency” could be found to exist
25 when the absence of action would cause the emergency event(s) to occur. Accordingly, we decline to
26 adopt interim rates based upon a temporary fair value finding.

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28 ⁸⁴ See Op. Att’y Gen. 71-17 at 15-16.

1 We cannot ignore the Court of Appeals' recent determination in *RUCO* that interim rate
2 making requires an emergency situation, the posting of a bond, and a subsequent full rate case in
3 order to meet the constitutional mandate that rates be just and reasonable. We find that there must be
4 an "emergency" under the first exception above, and that we have the authority to evaluate the
5 evidence on a case-by-case basis to determine whether an emergency exists.

6 The Attorney General Opinion discusses the criteria used to determine whether an emergency
7 exists – when a sudden change brings hardship to a company, when the company is insolvent, or
8 when the company's condition is such that its ability to maintain service while a rate case is pending
9 is in serious doubt. APS has not argued that a sudden change has brought hardship, nor does it assert
10 that it is insolvent or experiencing a financial emergency or cash flow crisis. It has not indicated that
11 it cannot pay current expenses or that it will be unable to provide safe and reliable service to
12 customers while the rate case is pending. APS' basis for an emergency is that S&P *may* downgrade
13 its bond rating from investment grade to non-investment grade if APS' FFO/Debt ratio decreases
14 below the desired level. In Decision No. 53909 (January 30, 1984), the Commission found that
15 emergency rates were appropriate due to an imminent risk of downgrade to non-investment rating.
16 At that time, APS was in the middle of an extensive construction program, building the Palo Verde
17 nuclear generating facility, and the Commission was concerned about APS' ability to finance the
18 construction necessary to honor contracts with Palo Verde's co-owners. We find that those
19 emergency circumstances are not present today – APS is not in danger of defaulting on contracts, its
20 construction budget is nowhere near what would be needed to build a nuclear plant and it has the
21 ability to manage its capital expenditures, its ratings are "stable," only one credit rating agency
22 currently rates APS "just one notch" above investment grade, its FFO/Debt ratio is still within the
23 desired range of ratios, its jurisdictional return on equity for 2008 is anticipated to be 8.4 percent, it
24 has Commission authority to issue additional equity, and its pending rate case is being processed
25 without delay.

26 Based upon the testimony and evidence presented at hearing, we find that no emergency
27 exists.

28 The second exception to the constitutional requirement that fair value must be considered in

1 setting just and reasonable rates is the *Mountain States* case where a Commission decision to not
2 grant a rate increase was appealed and the Superior Court found that the Commission had failed to
3 find the fair value of the company's property; that the previous rates did not provide a fair and
4 reasonable return on the company's property and resulted in the confiscation of the company's
5 property; and that pending the Commission's determination of just and reasonable rates, the company
6 must post a bond in order to put into effect temporary rates. The Commission appealed the judgment,
7 arguing that the court had no authority to allow the company to put interim rates into effect. The
8 Supreme Court stated that:

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10 The sole question, therefore, before this court is one of jurisdiction, for in
11 view of the fact that the record showed the commission had failed for nine
12 months after the company had applied for relief to grant any, and that the
13 trial court had reasons to believe such a situation would continue for an
14 unreasonable time and in fact has continued for almost a year *after*
15 judgment, it is obvious that unless in *some manner* there was immediately
16 established a temporary rate which the company might collect it would
17 have been compelled long since either to operate for an indefinite time
18 with insufficient revenue or to suspend operations during this period, with
19 consequences to business and society in Arizona truly appalling.⁸⁵

20 The parties' reliance on *Mountain States* as broad support for allowing interim rates absent
21 an emergency is misplaced. The case does not say, as some have implied, that whenever the
22 Commission's normal ratemaking process would not be completed in a reasonable time, the utility
23 has a right to interim rates. The procedural posture of the case involved a determination by a court
24 that the utility's rates were "confiscatory" and that the Commission had not determined fair value.
25 The court sent the case back to the Commission for rate setting in compliance with the court's finding
26 and allowed interim rates after a period of time when the Commission still had not set rates pursuant
27 to the court's decision. The case involved the jurisdictional issue of whether a utility could
28 implement rates after a court had made a determination that rates were unlawful. It did not establish
29 precedent that a utility could implement interim rates due to a belief that the normal ratemaking
30 process would not be completed in a reasonable time.

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1 No determination has been made here by the Commission or a court that current rates and
2 charges are not just and reasonable; therefore, *Mountain States* provides no basis for the
3 implementation of interim rates in this matter. Even if *Mountain States* were interpreted to allow
4 interim rates without an emergency, we do not agree that this pending rate case will not be resolved
5 within a reasonable time. APS has not ignored its obligation to be aware of its earnings, as it has
6 appropriately filed a rate application when it believed that its earnings were insufficient. However,
7 until the parties have audited, analyzed, and verified the data presented by APS, no determination can
8 be made of whether APS is entitled to a rate increase. The rate case application is being processed in
9 accordance with the Commission's adopted timeclock rules, and to date, no requests to extend or
10 delay that process have been made or granted. Further, unlike APS' previous rate cases, this
11 proceeding is not consolidated with other dockets involving substantial additional issues. And to the
12 extent that it is possible, APS and the parties are free to discuss whether agreement can be reached on
13 some or all of the rate case issues, thereby potentially reducing the time needed for hearing and
14 decision. Finally, APS should continue to monitor its financial condition and take steps when
15 necessary to insure that it remains financially strong. Our direction to APS in Decision No. 68685
16 (May 5, 2006) remains appropriate today:

17
18 However, APS should also look for ways to improve its cash flow, even looking
19 at expenses that are borne by shareholders and not ratepayers, especially when
20 credit rating agencies are focusing on its FFO/Debt ratio. Accordingly, while we
21 are not imposing restrictions on APS dividend payouts or dictating that certain
22 expenses be eliminated in this proceeding, we expect APS to manage its
23 operations in such a manner (including its generation assets) that with the relief
24 granted herein, together with the measures that APS itself adopts, its business
25 profile returns to 5, its FFO/Debt ratio continues to improve and its credit rating
26 remains investment grade.⁸⁶

27 It is not clear why, after more than two years during which we have granted an interim rate
28 increase, modifications to the PSA, a transmission cost adjustor, a permanent rate increase, and other
29 measures, APS is still having problems maintaining its FFO/Debt ratio.

30 The final exception to the constitutional requirement that rates consider fair value and be just

31 ⁸⁶ Decision No. 68685 at 29.

1 and reasonable is the adjustor mechanism. APS' request cannot be considered a "surcharge" under
2 the adjustment clause exception. The court stated in *RUCO*:

3
4 The surcharge in this case is not the product of an automatic adjustment
5 clause that existed before Rio Verde filed its application for a surcharge, nor
6 does the record reflect the existence of an automatic adjustment clause. We
7 agree with the court in *Scates*, and we acknowledge our concern for
8 "piecemeal" rate making as being "fraught with potential abuse." *Id.* at
9 534, 578 P.2d at 615.

10 Here, the Commission argues that the surcharge at issue can be fairly
11 classified as an automatic adjustment, with no showing that an automatic
12 adjustment was ever contemplated or that a clause was ever approved. The
13 Commission appears to argue that it can *sua sponte* declare a rate increase
14 based on an increase in the cost to a utility of a specific operating expense
15 under the guise of an automatic adjustment without there having been
16 consideration or approval of an automatic adjustment clause. Such an *ipse*
17 *dixit* approach not only offends the *Scates* court's concerns about piecemeal
18 rate making, but it also offends the constitutional mandate that rates be fair
19 and reasonable and made in the context of a fair valuation of all of a utility's
20 assets. See Ariz. Const. art. 15, § 3. If ever there was a situation "fraught
21 with potential abuse," *Scates*, 118 Ariz. at 534, 578 P.2d at 615, it occurs
22 when the Commission of its own volition has the ability to declare any rate
23 increase an "automatic adjustment."⁸⁷

24 APS' Motion requested that the amount of the expiring PSA surcharge be implemented as an
25 "Interim Base Rate Surcharge." Such an Interim Base Rate Surcharge would collect an increase in
26 base rates and increase APS' earnings. As the *Scates* court explained, adjustor mechanisms have
27 been upheld because:

28 The clauses are initially adopted as part of the utility's rate structure in
accordance with all statutory and constitutional requirements and, further,
because they are designed to insure that, through the adoption of a set formula
geared to a specific readily identifiable cost, the utility's profit or rate of return
does not change.⁸⁸

Here, it is clear that the surcharge requested was not adopted in a rate case and accordingly, it does
not qualify as an exception to the constitutional fair value finding requirement.

⁸⁷ *RUCO* 199 Ariz. at 593, 20 P.3d at 1174.

⁸⁸ *Scates* 118 Ariz. at 535, 578 P.2d at 617.

1 In conclusion, APS' Motion does not meet any of the recognized exceptions to the
2 constitutional requirement of fair value finding as set forth in Arizona case law, and we decline to
3 adopt a novel interpretation of the Arizona Constitution's fair value finding requirement and existing
4 state law in order to address this perceived potential downgrade of credit ratings. Accordingly, APS'
5 Motion should be denied without prejudice.

6 As discussed by Arizona courts, our ratemaking authority is sufficiently broad to enable us to
7 grant relief tailored to many different situations. "In some situations, that may be to grant emergency
8 rate relief, and in other situations, the circumstances or public interest may require other forms of
9 relief."⁸⁹

10 In Decision No. 68685, we noted that "APS' existing rate structure already has incorporated
11 one exception to the constitutional fair value finding requirement in the form of the PSA
12 mechanism."⁹⁰ Although we do not believe that APS has demonstrated that an emergency exists
13 currently, we are cognizant of the recent turmoil in the financial markets, of the state of the economy
14 in general,⁹¹ and of the risk that a downgrade to non-investment grade credit rating could have on
15 APS and its ratepayers. We agree that it is in the long-term best interests of APS and its customers
16 that APS have access to capital at attractive rates in order to fund needed future plant at a reasonable
17 cost. As discussed above, it is not clear why APS continues to claim it cannot maintain its FFO/Debt
18 ratios. To a large extent, this is within APS' control – it can monitor its cash, adjust its expenditures,
19 and seek an equity infusion when needed and appropriate. However, it is also apparent that APS'
20 FFO/Debt ratio may decline while the rate case is pending, increasing the risk that it will be
21 downgraded.

22 Because the consequences of a downgrade to junk status would negatively impact the rates
23 paid by ratepayers, we believe steps could be taken, consistent with the law, to improve APS' cash
24 flow in the short-term while we determine the reasons why APS is apparently continually unable to
25 sustain the desired FFO/Debt ratio. The current PSA has a 90/10 sharing provision that diminishes
26 APS' cash flow because APS is unable to collect ten percent of the purchased power and fuel costs

27 ⁸⁹ Decision No. 68685 at 23.

28 ⁹⁰ *Id.*

⁹¹ Some indicators suggest that the country is facing or in a recession.

that it incurs above base rates. In APS' last rate case we maintained that provision in order to provide APS incentive to acquire the most economical resources. The results of the recent fuel audit confirm that APS has managed its resource acquisitions appropriately. Recognizing that it is to the long-term benefit of Arizona and APS customers for APS to maintain a healthy financial condition, as the costs for future plant, generation, materials, capital, and service will be affected by APS' ability and cost to access the financial markets, we would be willing to address any appropriate motion or request pursuant to A.R.S. § 40-252 to modify the PSA to eliminate the 90/10 sharing until the permanent rate case where we could evaluate and resolve whether the sharing mechanism is causing or significantly contributing to the FFO/Debt ratio decline. In the rate proceeding we expect the parties to address this issue and to recommend whether the same or another sharing mechanism or other such incentive should be adopted as part of the PSA on a going forward basis. Although this PSA modification would have only a small positive effect on APS' cash flow and its FFO/Debt ratio, our willingness to consider it demonstrates that we are monitoring APS' financial condition and are ready to take appropriate measures to address the risks that APS and its customers are facing.

We also find that in the pending general rate case, APS should also present an analysis of what steps it has taken to improve its FFO/Debt ratio and why, after the Commission has implemented a forward looking PSA, a transmission cost adjustor, an environmental improvement surcharge, new base rates, and other measures, APS cannot improve and sustain that financial ratio. As part of this analysis, APS should present information regarding steps that have been taken, or may be taken in the future, to reduce costs (without diminishing service quality) and thereby increase available cash, including items such as dividend reductions, elimination of management bonuses, and other measures that would require stockholders to share the burden with ratepayers. Finally, we expect APS and Pinnacle West to closely monitor APS' financial condition and to take the steps necessary to maintain its investment grade credit rating.

* * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1
2 1. APS is a public service corporation principally engaged in furnishing electricity in the
3 State of Arizona. APS provides either retail or wholesale electric service to substantially all of
4 Arizona, with the major exceptions of the Tucson metropolitan area and about one-half of the
5 Phoenix metropolitan area. APS also generates, sells, and delivers electricity to wholesale customers
6 in the western United States.

7 2. On March 24, 2008, APS filed with the Commission an application for a rate increase.

8 3. On April 2, April 8, and April 14, 2008, Kroger, AECC, and Mesquite/SWPG/Bowie,
9 respectively, filed Motions to Intervene.

10 4. On April 30, 2008, the Town of Wickenburg filed a Motion to Intervene.

11 5. On April 25 and May 19, 2008, by Procedural Orders, the Motions to Intervene were
12 granted.

13 6. On June 2, 2008, APS filed an Amended Application.

14 7. On June 6, 2008, APS filed a Motion for Approval of Interim Rates and Preliminary
15 Order and requested a procedural conference be scheduled. In its Motion, APS requested the
16 Commission approve an "Interim Base Rate Surcharge" of \$.003987 per kWh to be effective upon
17 the expiration of the \$.003987 per kWh 2007 Power Supply Adjustor charge granted in Decision No.
18 69663.

19 8. On June 13, 2008, a Procedural Order was issued scheduling a procedural conference
20 on APS' Motion. Also on June 13, 2008, WRA/SWEEP filed a Petition for Leave to Intervene.

21 9. On June 16, 2008, RUCO filed an Application to Intervene.

22 10. On June 19, 2008, AIC filed a Motion to Intervene.

23 11. On June 19, 2008, the procedural conference was held as scheduled. Intervention was
24 granted to WRA/SWEEP, RUCO, AIC, and the Az-Ag Group. The parties were directed to meet and
25 discuss the Motion to see if there could be agreement on the procedural timeframes for the actions
26 requested by APS in its Motion and whether the parties could reach any other agreements. The
27 parties were directed to file either a joint recommendation or separate recommendations by June 30,
28 2008.

1 12. On June 30, 2008, the parties filed a Recommended Procedural Schedule.

2 13. On July 16, 2008, a Procedural Order was issued scheduling a hearing on the Motion
3 for Interim Rates to commence on September 15, 2008, and establishing associated procedural
4 requirements and deadlines; setting a public comment session and procedural conference for
5 September 11, 2008; and setting dates for the prefiling of witness testimony.

6 14. On July 23, 2008, the Hopi Tribe filed a Motion to Intervene, which was granted by
7 Procedural Order issued on August 4, 2008.

8 15. On July 29, 2008, a Procedural Order was issued scheduling the hearing on the
9 permanent rate case to commence on April 2, 2009.

10 16. On August 6, 2008, APS filed proof of publication of notice of hearing in compliance
11 with the July 16, 2008, Procedural Order.

12 17. On September 16, 2008, Commissioner Mayes docketed a letter requesting the parties
13 to address various issues during the hearing.

14 18. The public comment session and evidentiary hearing were held as scheduled, with the
15 hearing concluding on September 20, 2008. APS presented testimony from William Post, Donald
16 Brandt, Charles Cicchetti, and David Rumolo. AECC presented testimony from Kevin Higgins,
17 RUCO presented testimony from Stephen Ahearn, and Staff presented testimony from Ralph Smith
18 and David Parcell.

19 19. On September 26, 2008, APS filed its late-filed Exhibit 22.

20 20. On October 3, 2008, Chairman Gleason docketed a letter concerning the cost to
21 ratepayers if APS' credit rating falls to junk and asking APS to respond.

22 21. The Commission has received substantial public comment concerning the request for
23 an Interim Base Rate Surcharge.

24 22. Initial Closing Briefs were filed by APS, AIC, AECC, Mesquite, RUCO, and Staff on
25 October 3, 2008, and Reply Briefs were filed by APS, AIC, AECC, RUCO, and Staff on October 8,
26 2008.

27 23. On October 9, 2008, APS responded to Chairman Gleason's letter.

28 24. On October 14, 2008, APS filed its late-filed Exhibit 23.

1 25. APS has not demonstrated that an emergency exists or that its currently authorized
2 rates are confiscatory.

3 26. The pending general rate case is being processed in compliance with the
4 Commission's timeclock rules and no requests for delay have been requested or granted.

5 27. APS' requested Interim Base Rate Surcharge is not part of an adjustor mechanism
6 adopted in a permanent rate case where fair value was considered.

7 28. Given the current market conditions and the indication that the country is facing a
8 recession, it is reasonable to monitor APS' ability to access capital at reasonable terms in the short-
9 term and to acknowledge that steps should be taken to ensure that APS is financially healthy in the
10 long-term, for the future of Arizona and APS ratepayers.

11 29. APS has not articulated why it is fair or appropriate to routinely require ratepayers to
12 pay interim rate increases while permanent rate cases are being processed, but not to require a utility
13 to file for interim rate relief to decrease its rates when it is over earning.

14 30. It is not appropriate to create the opportunity to allow APS to seek non-emergency
15 interim rate increases while a general rate case is pending, because there is no concomitant obligation
16 on APS to file a general rate case when it is over earning, thereby not affording ratepayers the same
17 opportunity for interim rate relief that APS seeks for itself.

18 31. The Commission has the ability to determine what constitutes an emergency under
19 state law, has exercised that ability in previous Commission decisions, and there is no reason to craft
20 or invoke another exception to the constitutional requirement.

21 32. APS' existing rate structure already has incorporated one exception to the
22 constitutional fair value finding requirement, in the form of the PSA mechanism, which was
23 established to address the timely recovery of fuel and purchased power costs.

24 33. APS' cash flow is diminished by the 90/10 sharing provision in the PSA.

25 34. Given APS' assertion that its future cash flow will be insufficient to maintain a
26 FFO/Debt ratio necessary for investment-grade rating, APS should take any necessary and
27 appropriate steps, consistent with the law, to improve its cash flow in the short-term.

28 35. The issues of whether a PSA sharing provision is appropriate for the future and

1 .whether such provisions cause or significantly contribute to a decline in the FFO/Debt ratio, should
2 be addressed by the parties in the pending rate case.

3 36. We recognize that it is to the long-term benefit of Arizona and APS customers for
4 APS to maintain a healthy financial condition, as the costs for future plant, generation, materials,
5 capital, and service will be affected by APS' ability and cost to access the financial markets.

6 37. The discussion in Decision No. 68685 focusing on APS' need to take steps to manage
7 and improve its cash flow remains critical and important today, and we again find that APS and
8 Pinnacle West must take steps to insure that APS' financial ratios remain investment grade.

9 38. We find that in the pending general rate case, APS should present an analysis of what
10 steps it has taken to improve its FFO/Debt ratio and why, after the Commission has implemented a
11 forward looking PSA, a transmission cost adjustor, an environmental improvement surcharge, new
12 base rates, and other measures, APS cannot improve and sustain that financial ratio. The analysis
13 shall also include information regarding steps that have been taken, or may be taken in the future, to
14 reduce costs (without diminishing service quality) and thereby increase available cash, including
15 items such as dividend reductions, elimination of management bonuses, and other measures that
16 would require stockholders to share the burden with ratepayers.

17 39. We find that APS should file monthly reports on its and Pinnacle West's cash position
18 and financial ratios, including their projected cash flows, until the pending general rate proceeding is
19 resolved, and that Staff should monitor such filings in the pending general rate proceeding.

20 CONCLUSIONS OF LAW

21 1. APS is a public service corporation within the meaning of Article XV of the Arizona
22 Constitution and A.R.S. §§ 40-203, -204, -221, -250, -251, and -361.

23 2. The Commission has jurisdiction over APS and Pinnacle West and the subject matter
24 of the application.

25 3. Notice of the application was provided in accordance with the law.

26 4. No emergency exists to warrant the implementation of interim rates at this time.

27 5. APS' current rates are not confiscatory.

28 6. The Motion for an Interim Base Rate Surcharge should be denied without prejudice.

ORDER

IT IS THEREFORE ORDERED that Arizona Public Service Company's Motion for an Interim Base Rate Surcharge is hereby denied without prejudice.

IT IS FURTHER ORDERED that Arizona Public Service Company shall file monthly reports on Arizona Public Service Company's and Pinnacle West Capital Corporation's cash position and financial ratios, including their projected cash flows, until the pending general rate proceeding is resolved.

IT IS FURTHER ORDERED that Staff shall monitor such filings in the pending general rate proceeding.

IT IS FURTHER ORDERED that in the pending general rate case, Arizona Public Service Company shall present an analysis of what steps it has taken to improve its FFO/Debt ratio and why, after the Commission has implemented a forward looking PSA, a transmission cost adjustor, an environmental improvement surcharge, new base rates, and other measures, Arizona Public Service Company cannot improve and sustain that financial ratio. The analysis shall also include information regarding steps that have been taken, or may be taken in the future, to reduce costs (without diminishing service quality) and thereby increase available cash, including items such as dividend reductions, elimination of management bonuses, and other measures that would require stockholders to share the burden with ratepayers.

IT IS FURTHER ORDERED that in the pending general rate case, the parties shall address the issues of whether a PSA sharing provision is appropriate for the future and whether such provisions cause or significantly contribute to a decline in the FFO/Debt ratio.

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1 IT IS FURTHER ORDERED that Arizona Public Service Company and Pinnacle West
2 Capital Corporation shall take appropriate steps to insure that Arizona Public Service Company's
3 financial ratios remain investment grade.

4 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

5 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.
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7

8 CHAIRMAN

COMMISSIONER

9
10 COMMISSIONER

COMMISSIONER

COMMISSIONER

11 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
12 Director of the Arizona Corporation Commission, have
13 hereunto set my hand and caused the official seal of the
14 Commission to be affixed at the Capitol, in the City of Phoenix,
15 this _____ day of _____, 2008

16 _____
17 BRIAN C. McNEIL
EXECUTIVE DIRECTOR

18 DISSENT _____
19

20 DISSENT _____
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27
28

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ARIZONA PUBLIC SERVICE COMPANY

2 DOCKET NO.:

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